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No. —

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

On Appeal from the Supreme Court of New Mexico

JURISDICTIONAL STATEMENT

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QUESTIONS PRESENTED

1. Whether, under the "unitary business" test laid down by this Court in *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont,* 445 U.S. 425, 100 S.Ct. 1223 (1980), New Mexico's inclusion in Appellant's apportionable business income of dividends paid to Appellant by functionally independent foreign subsidiaries contravenes the Due Process Clause of the Fourteenth Amendment to the Constitution of the United States.

2. Whether New Mexico's inclusion in Appellant's apportionable business income of an amount equal to the "deemed paid" foreign tax credit allowed by the Federal government with respect to those dividends contravenes the Due Process Clause.

3. Whether New Mexico's inclusion of the dividends and "deemed paid" foreign tax credit in apportionable business income contravenes the Commerce Clause of Article I, Section 8 of the Constitution.

4. Whether, if some portion of the dividends or "deemed paid" foreign tax credit may constitutionally be included in Appellant's apportionable business income, the Due Process Clause will still be violated unless a correlative adjustment is made to New Mexico's apportionment factor.

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TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

On Appeal from the Supreme Court of New Mexico

JURISDICTIONAL STATEMENT

OPINIONS BELOW

The opinion of the Supreme Court of the State of New Mexico (the "New Mexico Supreme Court") is reported as *Taxation & Revenue Dept., etc.* v. *F. W. Woolworth,* 624 P.2d 28 (N.M. 1981). The opinion of the Court of Appeals of New Mexico (the "New Mexico Court of Appeals") is reported as *F. W. Woolworth* v. *Bureau of Revenue of N.M.,* 624 P.2d 51 (N.M. App. 1979). Included as Appendix A, *infra,* are copies of those opinions (App. A, *infra,* pp. 1a-22a and pp. 23a-29a, respectively) and the unreported Decision and Order of the Director of the Revenue Division of

the Taxation and Revenue Department of the State of New Mexico (the "New Mexico Taxation and Revenue Department") (App. A, *infra,* pp. 30a-38a).

JURISDICTION

This proceeding involves the application of New Mexico's Income Tax Act and Uniform Division of Income for Tax Purposes Act to (1) certain dividends which Appellant received from four of its foreign subsidiaries, and (2) the related foreign tax credits which Appellant claimed on its Federal income tax return for foreign taxes actually paid by the foreign subsidiaries. As is more fully described below, the New Mexico Taxation and Revenue Department upheld the asserted deficiencies whereupon Appellant took an administrative appeal to the New Mexico Court of Appeals. The New Mexico Court of Appeals reversed. However, this decision, in turn, was reversed by the New Mexico Supreme Court which rejected both Appellant's statutory challenge and constitutional challenge. Included as Appendix B, *infra,* are copies of the final Order of the New Mexico Supreme Court, dated January 30, 1981, and the Mandate of the New Mexico Court of Appeals, dated February 6, 1981.

Included as Appendix C, *infra,* is a copy of the Notice of Appeal which Appellant filed in the New Mexico Supreme Court on March 30, 1981.[1] This Jurisdictional Statement is being filed within 90 days of January 19, 1981, the date on which the New Mexico Supreme Court rendered its opinion upholding the constitutionality of the New Mexico statute as applied to Appellant. Accordingly, this Court has jurisdiction

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[1] Appellant also filed a copy of the Notice of Appeal in the New Mexico Court of Appeals on March 30, 1981.

under 28 U.S.C. § 1257(2). *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont,* 445 U.S. 425, 100 S.Ct. 1223 (1980) (hereinafter referred to as *"Mobil"*); *Moorman Mfg. Co.* v. *Bair,* 437 U.S. 267 (1978).

STATUTE INVOLVED

Sections 7-2-2(S), 7-2-2(T), 7-4-2(A), 7-4-3, 7-4-5, 7-4-8, 7-4-10, and 7-4-11 of the New Mexico Statutes 1978, Annotated ("N.M.S.A. 1978") are set forth in Appendix D, *infra.*[2]

STATEMENT OF THE CASE

F. W. Woolworth Co., the Appellant, is a New York corporation engaged in the retail business throughout the United States, Puerto Rico, and the Virgin Islands. It purchases a variety of consumer items (including dry goods, hardware, appliances, candy and some packaged food) and sells them at retail through Woolworth and Woolco stores. Most, if not all, of the stores also serve fountain items and meals. (App. A, *infra,* pp. 2a, 32a)

During its fiscal year in issue, which ended January 31, 1977 ("fiscal 1977"), Appellant received $39,881,161 in dividends from four of its foreign subsidiaries: F. W. Woolworth and Co., Limited, a 52.7 percent owned English subsidiary; F. W. Woolworth Co. GmbH, a wholly-owned German subsidiary; F. W.

[2] These statutory references are to the New Mexico statute as recodified in 1978 since these are the statutory provisions referred to in the opinion of the New Mexico Supreme Court. The substantive provisions, however, are the same as those in effect during the period in issue and were not amended or changed as part of the recodification.

Woolworth, Limited, a wholly-owned Canadian subsidiary; and F. W. Woolworth S.A. de C.V. Mexico, a wholly-owned Mexican subsidiary. (App. A, *infra*, pp. 26a, 33a, 35a)

These four subsidiaries are in the same general type of business as is Appellant, operating retail stores in their respective countries. They do no business, however, in New Mexico or elsewhere in the United States. In addition, as the record shows, their retail businesses are separate and distinct from Appellant's retail business in the United States. Each subsidiary carries on its own business autonomously and independently. Each subsidiary makes and carries out its own decisions with respect to size and location of stores, type of merchandise to be sold, advertising, accounting, personnel training and policies,[3] inventory purchases, and other operating procedures. Even where Appellant and its subsidiaries purchased inventory items in the same countries abroad (*e.g.*, in the Orient), the purchasing was done independently. (App. A, *infra*, pp. 33a-34a; Tr. 55-59)[4]

As a consequence of operating independently, each subsidiary conducts its retail business in a manner which varies from country to country, thereby responding to local tastes and needs. For example, in England, many of the stores have a restaurant and cafeteria as well as a supermarket section where food is sold. In Germany, there is an emphasis on soft goods

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[3] During the year in issue, none of the officers of the foreign subsidiaries was currently or formerly an employee of Appellant. (App. A, *infra*, p. 34a)

[4] The "Tr." reference is to the Transcript of the proceeding before the New Mexico Taxation and Revenue Department.

(such as dresses, clothing and coats, etc.) with no food selling operations. There also are differences in advertising methods from country to country. (App. A, *infra,* pp. 33a-34a; Tr. 56)

As noted by the New Mexico Supreme Court, Appellant, as the sole or major shareholder, has the power to control its foreign subsidiaries and has exercised some of this power as a consequence of carrying on the normal stewardship functions of a controlling shareholder. (App. A, *infra,* pp. 8a-9a) For example, Appellant had interlocking directors with some of the subsidiaries' Boards of Directors. Appellant also has performed some oversight functions and has determined the amount of the subsidiaries' dividend payments. (App. A, *infra,* pp. 8a-9a) The New Mexico Supreme Court also stated in its opinion, however, that "[t]here is some flow back and forth of goods and financial resources." (App. A, *infra,* p. 9a). Insofar as "goods" are concerned, this statement is simply inaccurate, contradicted by the record (Tr. 57, 95-98) and not based upon the findings of the Hearing Examiner of the New Mexico Taxation and Revenue Department (App. A, *infra,* pp. 33a-35a). The only references in the record or the Hearing Examiner's findings to a "flow" of "financial resources" involved Appellant's initial capital investments in the subsidiaries, small loans which may have been made to the English subsidiary,[5] and the dividends paid by the subsidiaries to Appellant. (App. A, *infra,* p. 35a; Tr. 61-63, 75-76, 79-83, 98-99)

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[5] In any event, such loans, if made, were repaid well before fiscal 1977, the year in issue. (Tr. 99)

Appellant elected on its Federal income tax return to claim credits rather than deductions for its foreign taxes. See sections 901 *et seq.* in subpart A of part III of subchapter N of the Internal Revenue Code (the "Code"). Consequently, under section 902(a) of the Code, Appellant was deemed, for purposes of the foreign tax credit provisions of the Code, as having paid a portion of the foreign taxes actually paid by the foreign subsidiaries from which Appellant received dividends. Such foreign taxes paid by a foreign subsidiary give rise to a "deemed paid" or "indirect" foreign tax credit. In addition, under section 78 of the Code, the amounts of such deemed paid credits were treated, for purposes of the Code, as dividends received by Appellant from the respective foreign subsidiaries.[6] This dividend treatment is commonly referred to as the "section 78 gross-up" or "gross-up".[7] In this case, Appellant's gross-up amounted to $25,502,782 for fiscal 1977, the taxable year in issue. (Tr. 171)

In filing its New Mexico tax return for fiscal 1977, Appellant apportioned its operating business income between sources within and without New Mexico on the basis of the three-factor formula prescribed by section 7-4-10, N.M.S.A. 1978. (See App. D, *infra,* p. 46a) This three-factor formula apportioned to New

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[6] Sections 902(a) and 78 of the Code are set forth in Appendix E, *infra.*

[7] For example, if a foreign subsidiary earns $100, pays foreign tax of $40, and pays a dividend of $30 out of its after-tax profits of $60, the "deemed-paid" foreign tax credit under section 902 is 30/60 x $40, or $20. The United States recipient includes $50 in dividend income (*i.e.*, the actual dividend of $30 plus $20 of "gross-up") and claims a foreign tax credit of $20 against the Federal income tax on this income.

Mexico that fraction of Appellant's total "business income" which was the average of the fractions of Appellant's total tangible property, payroll and sales attributable to New Mexico. Appellant did not include either its dividends from its foreign subsidiaries (*i.e.*, $39,881,161) or the related "gross-up" amount (*i.e.*, $25,502,782) in its apportionable business income.[8] Instead, Appellant allocated the dividends to New York, its commercial domicile, pursuant to section 7-4-8, N.M.S.A. 1978. (App. D, *infra*, p. 46a) Appellant's apportionable business income and New Mexico taxable income for fiscal 1977 were reported as $18,274,068 and $84,622, respectively. (Tr. 115)

On audit, the New Mexico Taxation and Revenue Department determined that (1) all of Appellant's dividends, gross-up, interest, and foreign exchange gain were includible in apportionable business income, and (2) the inclusion of these items in apportionable business income did not warrant any correlative decrease in Appellant's apportionment factor. Because of the large amounts involved, this adjustment increased Appellant's New Mexico taxable income from $84,622 to $401,518 for fiscal 1977. (Tr. 122)

Relying on both statutory and constitutional grounds, Appellant challenged the inclusion of the dividend,

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[8] Initially, Appellant also excluded $2,350,141 of interest and $1,595,551 of foreign exchange gain from its apportionable business income. (Tr. 43, 115.) At the outset of the proceeding before the New Mexico Taxation and Revenue Department, Appellant agreed to the inclusion of the interest in apportionable business income. (Tr. 41.) However, since the foreign exchange gain resulted from a hedging transaction whereby Appellant hedged the value of its investment in its English subsidiary, Appellant believes that disposition of this foreign exchange gain issue should be the same as the disposition of the dividend issue. (Tr. 43)

gross-up and foreign exchange gain in apportionable business income and, alternatively, the absence of appropriate factor modification. As indicated above, the New Mexico Court of Appeals upheld Appellant's primary statutory arguments concerning the measure of apportionable business income (thereby reversing the decision of the New Mexico Taxation and Revenue Department) without reaching the constitutional issues. (App. A, *infra,* pp. 23a-29a) This decision, in turn, was reversed by the New Mexico Supreme Court which rejected both Appellant's statutory and constitutional arguments. (App. A, *infra,* pp. 1a-22a)

REASONS FOR NOTING JURISDICTION

This case involves substantial constitutional issues. First, as is discussed more fully below, there is a need for this Court to resolve a conflict among the states and to clarify the constitutional limits of the "unitary business" test in *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont, supra.* In addition, other constitutional issues are presented here which were not considered or resolved in this Court's decisions in *Exxon Corp.* v. *Wisconsin Dept. of Revenue,* 447 U.S. 207, 100 S.Ct. 2109 (1980) or *Mobil.* For example, Appellant's alternative contention concerning the constitutional requirement for some adjustment to the apportionment factor in a case such as this was specifically identified and deliberately left unresolved by this Court in *Mobil.*

(1) Under the "Unitary Business" Test Laid Down by this Court in *Mobil,* New Mexico's Inclusion of the Dividends in Issue in Appellant's Apportionable Business Income Contravenes the Due Process Clause.

In *Mobil* this Court was confronted with the question of whether, under the Due Process Clause, a

nondomiciliary state (Vermont) could constitutionally tax (by inclusion in apportionable income) certain dividends received by a resident corporation [9] (Mobil) from other nonresident corporations having no contact with the taxing state. Based on this Court's preliminary determination that the business activities of the nonresident, dividend paying corporations were functionally integrated with Mobil's unitary petroleum business which, in part, was conducted in Vermont, the Court upheld the constitutionality of the Vermont tax as applied to Mobil, stating (100 S.Ct. at 1232-1233):

> "[T]he linchpin of apportionability in the field of state income taxation is the unitary business principle. In accord with this principle, what appellant must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State. *Bass, Ratcliff & Gretton* [266 U.S. 271 (1924)] forecloses the contention that the foreign source of the dividend income alone suffices for this purpose. Moreover, *appellant has made no effort to demonstrate that the foreign operations of its subsidiaries and affiliates are distinct in any business or economic sense from its petroleum sales activities in Vermont.* Indeed, all indications in the record are to the contrary, *since it appears that these foreign activities are part of appellant's integrated petroleum enterprise . . . Vermont was entitled to conclude that the dividend income's foreign source*

[9] As used hereinafter, the term "resident" corporation means a corporation which is doing business within the taxing state, but is organized under the laws of some other state and has its headquarters or commercial domicile in some other state.

did not destroy the requisite nexus with instate activities."

* * *

"Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. *So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability."* [Footnotes deleted; emphasis supplied]

It is apparent from the opinion of the New Mexico Supreme Court in this case and the March 4, 1981 opinion of the Idaho Supreme Court in *American Smelting & Refining Co.* v. *Idaho State Tax Commission* [10] that further clarification is needed from this Court on how to apply the "unitary business" test of *Mobil*. As shown by the cases discussed below, there is a conflict among the states at this time.

We think it plain that the test adopted by this Court in *Mobil* is whether the "underlying activity"—that is, the business of the dividend-paying corporation—is part of a "functionally integrated enterprise" being conducted, in part, by the resident corporation in the

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[10] The initial decision of the Idaho Supreme Court in *American Smelting* was in March, 1979, and is reported at 592 P.2d 39. This Court subsequently vacated that decision and remanded the case "for further consideration in light of" *Mobil. ASARCO, Inc.* v. *Idaho State Tax Commission*, 445 U.S. 939, 100 S.Ct. 1333 (1980). On remand, however, the Idaho Supreme Court simply issued a one paragraph, per curiam opinion reinstating its prior opinion. A copy of this recent opinion, dated March 4, 1981, is contained in Appendix F, *infra*.

taxing state. We also think it plain that Appellant's unitary business (*i.e.*, its retail business conducted throughout the United States, Puerto Rico, and the Virgin Islands) and the separate businesses of its dividend-paying foreign subsidiaries (*i.e.*, their retail businesses conducted in their respective countries) are not functionally integrated. As discussed above (pp. 4-5), each subsidiary carries on its own business autonomously and independently, making and carrying out its own decisions with respect to size and location of stores, type of merchandise to be sold, advertising, accounting, personnel training and policies, inventory purchases, and other operating procedures. (App. A, *infra*, pp. 33a-34a; Tr. 55-59)

Appellant's interpretation of the "unitary business" test in *Mobil* is also supported by *Square D Co.* v. *Kentucky Board of Tax Appeals*, 415 S.W.2d 594 (Ky. 1967) and *Gulf Oil Corp.* v. *Clayton*, 267 N.C. 15, 147 S.E.2d 522 (1966). In both cases, because the business operations of a parent and subsidiary were not integrated, the businesses were not treated as parts of a unitary business even though there was common ownership and both corporations were engaged in the same type of business. See also *American Bakeries Co.* v. *Johnson*, 259 N.C. 419, 131 S.E.2d 1 (1963).[11]

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[11] Similarly, where two businesses of a single corporation are not functionally integrated, the two businesses do not constitute a single unitary business. See, *e.g.*, this Court's opinion in *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, *supra*. In that case, income derived from the sale of crude oil and gas to third parties at the wellhead was excluded from the apportionable income of Exxon's unitary petroleum business. See also *Commonwealth* v. *Advance-Wilson Industries, Inc.*, 317 A.2d 642 (Pa. 1974), where a single corporation conducted two different businesses, a ceramic tile business and an electrolyzing business, which were held to be separate

It is apparent, however, that the New Mexico Supreme Court has applied a different test in this case. Rather than look to whether the "underlying activities" of the dividend paying subsidiaries were functionally integrated with Appellant's business, the court has focused on Appellant's powers and status as the controlling shareholder of its subsidiaries.[12] As described above (p. 5), the court emphasized Appellant's stewardship activities (as the controlling shareholder), including representation on some of the subsidiaries' Boards of Directors and determination of dividend payments. Such activities, however, are perfectly consistent with Appellant's assertion that there was no functional integration of Appellant's retail business with the retail businesses of the subsidiaries. Thus, these stewardship activities are insufficient to cause the dividends received by Appellant from its foreign subsidiaries to be part of Appellant's apportionable business income from the conduct of its retail business in New Mexico (or any other nondomiciliary state). These dividends lack the requisite "nexus" with New Mexico. *Moorman Mfg. Co.* v. *Bair, supra.*

It is important for this Court to resolve the conflict among the states and to clarify the constitutional limits of the "unitary business" concept. In view of this case

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businesses. It did not matter that both businesses were conducted as divisions of the same corporation so that there was common ownership and control, or that the home office performed certain administrative and other functions for both divisions

[12] This approach is consistent with the approach taken by the Idaho Supreme Court in its initial opinion in *American Smelting.* As is discussed in footnote 10, *supra,* that opinion was reinstated following the remand from this Court.

and the recent Idaho opinion, there is an obvious need for this Court to now do what the Idaho Supreme Court failed to do on remand—that is, to give further consideration to the unitary business test "in light of" *Mobil*. In this regard, Appellant has been authorized by ASARCO, Inc. to state here that ASARCO intends to appeal again to this Court from the decision of the Idaho Supreme Court. Thus, this Court will have ample opportunity to fully consider and clarify the unitary business test of *Mobil*.

(2) New Mexico's Inclusion of the Section 78 Gross-Up Amount in Appellant's Apportionable Business Income Contravenes the Due Process Clause.

The treatment of the Federal section 78 gross-up is a substantial issue which warrants this Court's attention. The issue potentially arises in those states where (a) a corporation's Federal taxable income is used as the starting point in determining the corporation's apportionable business income, and (b) there is no additional, corrective statutory provision which provides for the deduction of the section 78 gross-up. At the present time eleven states (including New Mexico) have statutes which satisfy both of these conditions.[13]

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[13] Thirty-three states satisfy the first condition—*i.e.*, they use Federal taxable income as the starting point in determining apportionable business income. Sixteen of these states have solved the section 78 gross-up problem by also enacting legislation which specifically provides for a deduction of the gross-up. Another six states deduct dividends generally from taxable income, thereby (presumably) also deducting the gross-up. See, *e.g.*, *Dow Chemical Co.* v. *Commissioner of Revenue*, 391 N.E.2d 253, 263-266 (Mass. 1979). Under section 78 of the Code, the gross-up is treated as a dividend from the foreign corporation. In *Dow*, therefore, the Court accepted this characterization of the gross-up as a "divi-

In addition, other states are attempting to tax the gross-up in taxable years not covered by new legislation which may have cured the problem prospectively. See, *e.g., Caterpillar Tractor Co.* v. *Lenckos,* 77 Ill. App.3d 90, 395 N.E.2d 1167 (1979) which was affirmed by the Illinois Supreme Court (Nos. 52818, 52828 and 52903, decided February 20, 1981).

As a general proposition, Appellant does not dispute a nondomiciliary state's use of a resident corporation's Federal taxable income in determining the corporation's apportionable business income.[14] However, where that Federal taxable income contains a section 78 gross-up amount, some further adjustment is constitutionally required. The inclusion of this admittedly "fictional amount" (App. A, *infra,* p. 3a) in apportionable business income at the state level inevitably contravenes the Due Process Clause by apportioning to the nondomiciliary state an amount which is "out of all appropriate proportion to the business transacted . . . in that state." *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell,* 283 U.S. 123, 135 (1931).

Under section 78 of the Code, a corporation's deemed-paid foreign tax credit (*i.e.,* the gross-up amount) is

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dend" and allowed a deduction of the gross-up under the provision in the Massachusetts statute providing for the deduction generally of dividends. Appendix G, *infra,* contains a chart showing which states base their taxable income on Federal taxable income, and which states also have enacted provisions either deducting the section 78 gross-up specifically or dividends generally.

[14] Appellant recognizes the legitimate objectives of doing this "for the convenience of the taxpayer, as a savings to the State, and to provide the State with a means of verifying the accuracy and honesty of a taxpayer's return." *Getty Oil Co.* v. *Taxation and Revenue Dept.,* 93 N.M. 589, 592, 603 P.2d 328, 331 (Ct. App. 1979).

"treated" as a dividend only when the corporation claims a credit (rather than a deduction) for its foreign taxes.[15] Prior to the enactment of section 78 in 1962, the election to claim a foreign tax credit did not require this inclusion of the gross-up amount in taxable income. The legislative history to section 78 clearly and explicitly states that the sole purpose for the change was to increase the United States parent corporation's effective overall tax rate on the income of its foreign subsidiary in those instances in which the parent corporation claimed foreign tax credits. Thus, the issue was not to measure the taxpayer's "gross income" or "taxable income". The issue was to achieve a mechanism which, taking into account the corporation's foreign tax credit, would arrive at the appropriate overall tax rate for Federal income tax purposes. See S. Rep. No. 1881, 87th Cong., 2d Sess., pp. 66-71 (1962-3 C.B. 707, 772-777) and H. Rep. No. 1447, 87th Cong., 2d Sess., pp. 50-53 (1962-3 C.B. 405, 454-457) which accompanied the Revenue Act of 1962, P.L. 87-834, 76 Stat. 960.

The question, therefore, is whether, under these circumstances, a nondomiciliary state can take this fictional amount into account in determining the taxable income of a resident corporation from the corporation's activities in the state. Appellant's foreign tax credit election on its Federal income tax return should be irrelevant to New Mexico's determination of Appellant's taxable income in New Mexico. The value of its activities in New Mexico is unrelated to this elec-

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[15] Obviously, if the gross-up truly constituted an item of income, it would have been unnecessary to enact section 78 in order to achieve that "treatment".

tion. For New Mexico to increase Appellant's apportionable business income by $25,502,782 as a consequence of Appellant's Federal foreign tax credit election makes no sense, results in an excessive apportionment to New Mexico, and is constitutionally infirm. *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission,* 390 U.S. 317 (1968); *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell, supra.*

In view of the New Mexico Supreme Court's reliance on the Vermont decision in *F. W. Woolworth* v. *Commissioner of Taxes,* 130 Vt. 544, 298 A.2d 839 (1972)[16] it is ironic that the clearest support for Appellant's position now comes from Vermont. The Vermont Supreme Court did initially hold in *Woolworth* that the section 78 gross-up could be treated as income because, as a consequence of making its foreign tax credit election on its Federal income tax return, the taxpayer realized the economic benefit of reducing its overall Federal income tax liability. However, that decision was overrruled and repudiated by the Vermont Supreme Court in its recent decision in *In re Appeal of Norris Knosher* (No. 203-80, decided February 3, 1981).[17]

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[16] See App. A, *infra,* pp. 5a-6a.

[17] Under the Vermont statute in issue in *Knosher,* the taxpayer's Vermont income tax liability was defined as 25 percent of his Federal income tax liability, determined without regard to the new credit provided for in section 51 of the Code for wages paid to certain employees. In determining his Federal tax, Mr. Knosher claimed the credit, thereby also reducing his deduction for wages. See section 280C of the Code. The issue, therefore, was whether, for Vermont income tax purposes, Mr. Knosher could redetermine his Federal tax liability as though he had not claimed the credit,

It is also important to note that, as part of its 1972 *Woolworth* opinion, the Vermont Supreme Court also required the Commissioner to adjust the apportionment formula to reflect the activities of the foreign subsidiaries whose dividends gave rise to the gross-up. See 298 A.2d at 845-846. The New Mexico Supreme Court refused to give the same apportionment formula relief in this case. Thus, even if Vermont's decision in *Woolworth* still had vitality, it would not support the *result* in this case.

Nor, insofar as the constitutional issue presented here is concerned, is there any other support for the result below. In *Dow Chemical Co.* v. *Commissioner of Revenue, supra,* for example, Dow's taxable income was not increased by the gross-up since the gross-up was deducted under the Massachusetts statute as a dividend. See footnote 13, *supra.* Thus, the constitu-

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but, instead, had claimed a larger deduction for wages. In deciding for the taxpayer, the court also held (Slip. Op. 3):

> "We believe that our holding in the present case is inconsistent with our earlier decision in *F. W. Woolworth Co.* v. *Commissioner of Taxes*, 130 Vt. 544, 298 A.2d 839 (1972). *Woolworth* concerned the interpretation of a different statutory provision and was not cited by the Department, but the issue is analogous to that of the case at hand. Justice Larrow, in a dissenting opinion in a later related case, criticized the reasoning in *Woolworth, F. W. Woolworth* v. *Commissioner of Taxes*, 133 Vt. 93, 100, 328 A.2d 402, 407 (1974). We find his dissent more persuasive than the opinion in the earlier *Woolworth* decision, and do not consider that decision to be controlling in the case at hand. To the extent that the opinion in *F. W. Woolworth* v. *Commissioner of Taxes, supra,* 130 Vt. 544, 298 A.2d 839 (1972), is inconsistent with our decision in the present case, it is overruled."

tional issue presented here was not reached."[18] Similarly, in *Caterpillar Tractor Co.* v. *Lenckos, supra,* the constitutional issue was not reached because it was not presented to the court; the only issue was one of statutory construction.

Finally, even if this Court should conclude that the section 78 gross-up may constitutionally be included by a nondomiciliary state in income, there is the further question of whether the gross-up may constitutionally be included in apportionable business income. In this regard the New Mexico Supreme Court stated (App. A, *infra,* pp. 7a-8a):

> "We reverse the decision of the Court of Appeals which, in effect, would give Woolworth a deduction from the line 30 figure without statutory authority on the grounds that gross-up is not in fact dividend income and cannot be classified as 'business income.' We do not think the question involves a determination of whether the income is classified as 'business income.' Rather, we hold that it involves consideration of a statute that is constitutional, unambiguous and not subject to statutory construction. *See Hutchinson* v. *State,* 89 N.M. 501, 554 P.2d 663 (1976)."

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[18] However, in this regard, it is instructive to note the Massachusetts Supreme Judicial Court's statement that (391 N.E.2d at 265):

> "The gross-up-foreign tax credit symbiosis is a means of calculating a suitable Federal tax credit for the United States parent and in truth it is a strain to deal with any part of it as 'income' for state purposes."

In the same vein, the New Mexico Supreme Court, in its opinion below, referred to the section 78 gross-up as "a fictional amount representing 'dividends deemed to have been received'" and as "the fictitious gross-up." (App. A, *infra,* pp. 3a, 5a)

Appellant disagrees. The answer to the preliminary question of whether the section 78 gross-up may be treated as income does not answer the further question of whether the gross-up may be treated as part of the apportionable business income of Appellant's unitary business. Appellant contends that there is no connection between *its* domestic retail business and the fictional gross-up for foreign taxes paid by its foreign subsidiaries.

(3) New Mexico's Inclusion of the Dividends and the Section 78 Gross-Up Amount in Apportionable Business Income Also Contravenes the Commerce Clause.

The dividends: Mobil also involved the application of the Commerce Clause. Mobil argued that (100 S.Ct. at 1234):

> ". . . Vermont's tax imposes a burden on interstate and foreign commerce by subjecting [Mobil's] dividend income to a substantial risk of multiple taxation."

Mobil premised this "multiple taxation" argument on the assumption that all of its dividend income was fully taxable in the state of commercial domicile and, therefore, any apportionment to Vermont unavoidably subjected Mobil to the risk of multiple taxation at the state level. In deciding the Commerce Clause issue against Mobil, this Court rejected the premise for Mobil's argument. That is, the Court rejected Mobil's assumption that the dividends would necessarily be subject to tax in the state of commercial domicile.

Appellant's "multiple taxation" argument goes beyond Mobil's and, therefore, was not dealt with by this Court. Mobil's argument centered on the "risk" of multiple taxation by both the state of commercial

domicile and another nondomiciliary state. Here, however, as was found below (App. A, *infra*, pp. 31a-32a), Appellant actually paid foreign withholding taxes on its foreign source dividends.[19] In such a case, *any* state taxation (even by the state of commercial domicile) "creates more than the *risk* of multiple taxation: it creates multiple taxation in fact." *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 99 S.Ct. 1813 (1979).

The section 78 gross-up: New Mexico's taxation of the gross-up simply exacerbates an already unconstitutional situation by increasing the discriminatory treatment of dividends from foreign subsidiaries. Assume, for example, that a domestic subsidiary had Federal taxable income of $100 on which it paid a Federal income tax of $46. If the subsidiary then paid the balance ($54) to its corporate parent, New Mexico would include at most $8.10 in apportionable business income (*i.e.*, $54 less the 85 percent dividends received deduction allowed by the Code).[20] By contrast, if the same subsidiary were a foreign subsidiary which paid $46 in foreign taxes and the corporate parent claimed

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[19] In this regard, see Income Tax Act sub-s 212(2) and 215(1) (Canada); EStG §§ 20(1) No. 1, 43(1) No. 1, 50(5) and KStG § 50(2) No. 2 (Germany); and Income Tax Law, Articles 60, V and 73, I (Mexico) which subject dividends to a tax which is imposed on the recipient, but withheld by the payor. England has a more complicated procedure which has the same effect as a withholding tax and need not be summarized here.

[20] The dividends received deduction would be available because of New Mexico's utilization of the Federal tax base. If the corporations filed a consolidated return or were eligible for the 100 percent dividends received deduction, no portion of the dividend would be includible by New Mexico in apportionable business income.

a credit for foreign taxes, New Mexico would include $100 in apportionable business income (*i.e.*, the full dividend of $54 plus the gross-up of $46). There would be no double taxation at the Federal level because of the accompanying foreign tax credit. Obviously, however, there is excessive taxation at the state level. There would be multiple taxation of the income of the foreign subsidiary as well as multiple taxation of the income of the United States parent. Under these circumstances, the New Mexico statute places an impermissible burden on foreign commerce. The statute discriminates against foreign commerce and impairs Federal uniformity in regulating commercial relations with foreign governments. *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977); *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276 (1976).

(4) If Some Portion of the Dividends or Gross-Up May Constitutionally Be Included in Appellant's Apportionable Business Income, the Due Process Clause Will Still Be Violated Unless a Correlative Adjustment Is Made to New Mexico's Apportionment Factor.

As noted above, this issue was deliberately and explicitly left unresolved in *Mobil*. On three separate occasions, the majority opinion states that the issue was not considered because Mobil did not raise it. See 100 S.Ct. at 1230, 1233, n. 15 and 1237. Mr. Justice Stevens' dissent in *Mobil* makes it clear, however, that he would require an adjustment to the apportionment factor in a case like this. In this regard, his dissent states (100 S.Ct. at 1243):

> "Unless the sales, payroll and property values connected with the production of income by the [dividend] payor corporations are added to the denominator of the apportionment formula, the inclusion

> of earnings attributable to those corporations in the apportionable tax base will *inevitably* cause Mobil's Vermont income to be overstated." [Emphasis added]

The reason for Mr. Justice Stevens' conclusion is clear. A nondomiciliary state can properly tax a resident corporation only on that portion of its income which is attributable to its activities in the nondomiciliary state. In determining that amount, it should make no difference whether the corporation's unitary business is conducted through operating divisions or separately incorporated subsidiaries. As this Court stated in *Mobil* (100 S.Ct. 1233):

> "Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441, 84 S.Ct. 1564, 1568, 12 L.Ed.2d 430 (1964). *Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.*" [Emphasis supplied]

The results of operating a taxpayer's unitary business through a subsidiary will *not* be the same, however, as the results of operating through a division unless the taxpayer's apportionment factor is appropriately adjusted when dividends paid by the subsidiary are included in apportionable business income.[21]

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[21] This can be demonstrated by assuming that the taxpayer conducts a unitary business through two divisions (Division A, which

Thus, unless the taxpayer's apportionment factor is adjusted when dividends are included in apportion-

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operates both inside and outside New Mexico, and Division B, which operates entirely outside New Mexico). Assume the following figures:

	Division A		Division B	
	All Locations	New Mexico Situs	All Locations	New Mexico Situs
Property	$200,000	$20,000	$100,000	-0-
Sales	400,000	40,000	200,000	-0-
Payroll	200,000	20,000	100,000	-0-
Business Income	$ 20,000		$ 10,000	

On these facts, the income apportionable to New Mexico would be $2,000 computed as follows:

Total Business Income $30,000

New Mexico Factors:

$$\left[\frac{\text{Property } 20{,}000}{300{,}000} + \frac{\text{Sales } 40{,}000}{600{,}000} + \frac{\text{Payroll } 20{,}000}{300{,}000} \right] \div 3 = 6\tfrac{2}{3}\%$$

New Mexico Taxable Income = $30,000 × .06⅔ = $2,000

However, if the business of Division B were operated through a wholly-owned subsidiary corporation, and all income of the subsidiary were distributed as a dividend to the parent and treated as apportionable business income without any adjustment in the parent's apportionment factor, the income apportioned to New Mexico would be increased by 50% to $3,000, computed as follows:

Parent's Business Income = $20,000 + 10,000 =$30,000

Parent's New Mexico Factors:

$$\left[\frac{\text{Property } 20{,}000}{200{,}000} + \frac{\text{Sales } 40{,}000}{400{,}000} + \frac{\text{Payroll } 20{,}000}{200{,}000} \right] \div 3 = 10\%$$

New Mexico Taxable Income = $30,000 × .10 = $3,000

able business income (in order to reflect the subsidiary's payroll, sales and property which generated the dividends), the result will inevitably violate the Due Process Clause by apportioning too much income to the taxing state.[22] *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission, supra; Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell, supra; People el rel. Alpha Portland Cement Co.* v. *Knapp,* 230 N.Y. 48, 129 N.E. 202 (1920).

Absent any appropriate adjustment to the apportionment factor, the nondomiciliary state will, in effect, be taxing directly a portion of the subsidiary's income—all of which was earned by activities conducted outside the nondomiciliary state. Such taxation of "extraterritorial values" is far different from taking the subsidiary's dividends into account, as part of the overall apportionment procedure, for the purpose of determining a parent corporation's income from its activities conducted within the taxing state. *Butler Bros.* v. *McColgan,* 315 U.S. 501, 507 (1942).

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[22] In this case, for example, New Mexico's inclusion of foreign source dividends and the gross-up in Appellant's apportionable business income for fiscal 1977 caused an increase from $18,274,068 (as initially reported) to $83,658,011. This increase, coupled with New Mexico's failure to adjust appropriately the apportionment factor, caused Appellant's New Mexico taxable income to be increased from $84,622 to $401,518. (Tr. 115)

The New Mexico Taxation and Revenue Department did include the amount of Appellant's dividend income and gross-up in the denominator of the sales fraction. But this token adjustment was plainly inadequate to reflect the subsidiaries' underlying sales, assets and payroll which produced the distributed income and clearly would have been taken into account had the businesses been run in a division of Appellant rather than in subsidiaries.

Finally, it is important to note that *Mobil* only involved the inclusion of dividends in apportionable business income. This case also involves the inclusion of $25,502,702 of section 78 gross-up in Appellant's apportionable business income. As the Vermont Supreme Court recognized in its *Woolworth* decision, the need to adjust the apportionment factor is particularly compelling when gross-up is involved. Thus, this case presents an excellent opportunity for this Court to consider fully the relationship between the determination of the apportionable income base and the apportionment fraction.

CONCLUSION

For the foregoing reasons, this Court should note probable jurisdiction of the appeal.

Respectfully submitted,

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